

Alternative Fee Arrangements for Corporate Clients

By Steven A. Lauer © 1999 *

Corporate clients are imposing many restrictions and changes on the law firms that serve them. In many cases, they are reducing dramatically the number of firms to which they will assign the day-to-day legal work they require. They are embracing tools and concepts such as task-based billing, partnering and budgeting for legal matters. The relationship between a law firm and its corporate clients is or may soon be very different than it has been.

The clients are also exploring the use of alternative fee arrangements, a term that generally means any method of calculating a legal fee other than by simply multiplying the number of hours expended by the per-hour rate of the attorney. The hourly rate is younger than the baby boomers who are often the individuals questioning its validity. Why is the hourly rate in disrepute?

The answer is that the hourly rate is perceived as creating incentives for outside counsel that are not consistent with the interests of their clients. A fee based on the length of time that it takes counsel to complete an assignment is perceived as rewarding inefficiency. The attorney who takes twice as long to complete a task as another stands to be paid twice as much as a second, more-efficient attorney unless the resulting calculation is adjusted to reflect relative efficiency. Such an adjustment would be difficult at best and certainly subjective in nature.

The hourly rate has led to developments such as the industry known as “fee auditors.” While such persons are often retained to review fees to be imposed on one party to a lawsuit as part of the victory by that party’s opponent (in “fee shifting” cases), they are also retained by the clients of the law firms whose bills they analyze. They have become popular with insurance companies. In many cases, they second-guess the amount of time billed by the firms for projects and cases. They often monitor adherence by counsel to billing guidelines that the corporate clients have promulgated.

Not surprisingly, the firms whose bills are scrutinized have not always accepted the activities of the fee auditors too gladly. Relationships between firms and their clients have been affected adversely by the conclusions of the audits in some cases. See Brennan, “Driven to Defection,” National Law Journal (May 18, 1998), pp. A1, A27. Such audits have even spawned litigation between firms, their clients and the auditing firms.

Whether the soured relationship resulted from the use by the client of a fee auditor or whether the souring of the relationship predated the client’s retention of the auditor is perhaps an unnecessary inquiry. Either way one answers that question, however, there is “bad blood” between many clients and the firms that serve them. There probably are relationships that have already reached such a point even though the law firms involved may not be aware of it.

Firms should proactively address the malaise (or worse) that afflicts many relationships with clients. To pretend that clients are copacetic because they have not complained invites disaster in the form of lost clients or fee disputes.

What can they do? They can, and should, address the perceived (and actual) disincentives that the hourly rate creates. They should propose alternative fee structures to their clients.

* Mr. Lauer is a consultant on the efficient delivery of legal services to corporate clients. He has over 13 years’ experience as an in-house attorney in several organizations. Previously, he spent six years in private practice. He is based in Maplewood, New Jersey. His phone is (973) 763-6340 and he can be reached by e-mail at stevelauer@sprintmail.com.

In saying this, of course, I recognize that the prescription is much simpler than its implementation. As I said above, the term alternative fee is an elastic one. It is defined by what it is not, rather than by what it is. In proposing alternative fees, law firms must be sensitive to their clients' needs and desires, because the design of an alternative fee will vary from client to client and from situation to situation.

What are those needs and desires? While I obviously can't speak for all clients in all contexts, there are some concerns that I believe are common to most if not all corporate clients. It is important that firms also understand the pressures that bear on in-house counsel in the present climate, since those pressures will affect the perspective of the inside lawyers in addressing the question of alternative fees.

The primary goals of corporate clients, in terms of the fees that they pay their outside counsel, are lowering their expenses, budgetary certainty, value and an alignment of interests. What do these mean? How do they relate to alternative fee arrangements?

The increasing focus of corporate America on costs means that law departments of corporations must "do more with less" (to borrow an oft-heard phrase). The total costs of corporate legal service must be reviewed and, as far as possible, reduced or at least controlled.

The second goal – budgetary certainty – means that a law department, like all other corporate departments, must submit a budget for its part of the enterprise operation. While this has long been true, the environment of the 90s means that budget overruns will not be countenanced without good justification. Accordingly, the more a law department can plan its future costs, **and be confident that the actual outlays will not exceed the budgeted amounts**, the more secure that law department, and the client, will be.

The third goal is value. Legal costs have been uncontrolled for years (from the perspective of corporate executives, at least). Often, that cost has borne little relation to the resulting work product. A limited assignment might have cost more than what appeared to the business client as the more important portion of the assignment. (An example might be an opinion letter for a transaction, with the opinion letter costing more than the efforts of counsel to draft the necessary documents.)

The fourth goal is an alignment of interests. I have heard corporate counsel often express, in different contexts, a desire that outside counsel demonstrate that the interests of client and firm are truly aligned (not simply that counsel express that view, but also effect the sentiment). For example, outside counsel knowingly forgoing a short-term economic benefit (such as some billings) to assist the client in achieving a particular goal would be a dramatic display of the type of alignment of interests desired.

How can these goals animate the approach to alternative fees? In general terms, they can assist counsel (inside and outside) to design a fee structure that fits the vagaries of a client's situation. A firm that plans to suggest an alternative fee should be aware of the ways in which each type of fee might address the clients needs as well as the ways in which it might not. Some fees can have impacts that make them less than desirable from the client's position also. Let's look at a few examples.

A reduced hourly rate might appear to satisfy the first goal (reduced expense). Very often, that is the first type of alternative fee that comes to mind, and on first blush it seems like a quick fix. The overall cost of the legal service is still unconstrained, however. A reduced hourly rate merely increases the need to manage the work in order to keep the amount of time taken to complete the task from unintentionally expanding and eliminating the hourly saving. Because the fee structure still creates no incentives for the firm to control the amount of time devoted to the assignment, the task of managing the time falls on the shoulders of the in-house attorneys. If inside counsel is unable to manage the work so closely (due to insufficient staff to monitor progress in such detail, for example), then the client's goal of reduced cost may not be met. If the client increases staff in order to assure such oversight, the savings may also be reduced.

A fixed fee for a legal service provides greater certainty in budget terms. Obviously, when a law firm proposes a fixed fee, it does so with certain assumptions in mind, such as the amount and types of legal expertise that would be needed to properly complete the assignment. So long as the law firm is correct as to those assumptions, the firm and the client both will be satisfied. The accuracy of assumptions

about the amount and types of legal work that will be necessary to complete an assignment is far from assured, however. Accordingly, the firm and the client may both be unwilling to take the risk that the fee agreed to at the beginning will turn out after completion to have been appropriate for both of them.

From the client's perspective, however, a flat or fixed fee has a quality that makes it very attractive. The fee places on the shoulders of the law firm the burden of assuring that the amount and types of work actually devoted to the task are commensurate with the value (at least, the value as reflected in the size of the agreed-to fee). Since the firm has greater control of those variables than does the client, in the client's mind, that burden should be on the outside firm.

A contingent fee places the greatest risk on the outside firm. Effectively, that type of arrangement requires that the firm literally "put its money where its mouth is" because the firm receives no fee unless its work is successful. The client has no risk other than the costs associated with the assignment (*e.g.*, court filing fees and other out-of-pocket costs). For a firm, however, a contingent fee has another adverse effect – it has a very negative impact on the firm's cash flow because the firm's expenses (rent, salaries, etc.) continue even while the fee (assuming success) is yet unrealized. Accordingly, a client must be cognizant of that effect, since it should not want to have counsel living hand-to-mouth during the pendency of the matter. In some jurisdictions, there are even ethical considerations that can make the contingent fee unavailable in some contexts.

A firm and client might agree that all time devoted by the firm's personnel might be charged at the same hourly rate regardless of the seniority or expertise of each billing professional. Sometimes a different rate is quoted for partners than for associates than for legal assistants. This is a "blended" hourly rate. This seems to have the benefit (for the client) of reducing the need to oversee who within the firm is completing which part of an assignment. The blended rate creates incentives for the firm to delegate tasks to lower-level personnel (less-senior rather than more-senior associates, for example). Since many clients have expressed the view that the hourly rate creates incentives to move work up the seniority ladder within a firm (since more-senior professionals bill at higher rates, leading to greater cash flow), this arrangement seems to satisfy a client need. Care must guide the negotiation, however, because those incentives can have greater-than-desired effects. The delegation might be too far and too often, to the detriment of the quality of the work. Again, a greater management burden is one result, an often-unanticipated one.

A firm and a client might agree that the fee would be determined after the assignment is completed and that it would be calculated on the basis of the value that the legal work added to the entire project (such as a transaction). This arrangement clearly and most directly addresses the client's desire that the cost of the legal work be commensurate with the purpose of that work. The client and firm need to discuss in advance (and agree) who will determine that fee value and by what standards. Will it be an entirely subjective determination by the client? Will it be set by comparison to fees of counsel in other, comparable deals? If they haven't agreed on such issues ahead of time, the firm and client may very well find themselves at loggerheads after one or the other sets the fee. At that point, the only resolution may be fee arbitration or another less-than-desirable means of resolving a difference of opinion on such a critical issue.

A form of fixed fee is a retainer for an anticipated volume or type of work. The client gets budget certainty. The firm gets some benefits as well. It will expect a greater volume of work than it otherwise would have received. It will benefit from a more-predictable cash flow (if the retainer arrangement calls for payment by the client of a set amount on a preset basis). The greater volume of work (particularly if that work consists of similar matters over time) will enable it to introduce some efficiencies into its work on behalf of that client.

In a retainer for work volume, the firm takes on some risk. The volume of work may exceed by an unexpectedly great amount the anticipated volume, causing the firm to be paid a less-profitable fee (as measured on a per-matter basis) than planned. The client takes the countervailing risk, however, that the amount of work will be less than anticipated, so that it pays the firm a fee that is more remunerative (similarly measured) than either had expected.

There are other types of fee arrangements possible. The variety is limited only by the collective imagination and risk tolerances of the client and firm. Each has its unique benefits and risks for each of the client and firm. Each can have different impacts on the incentives of the firm and the client.

They must anticipate those potential effects when they discuss the potential fee. Moreover, there are other issues that they must address in advance, as well. For example, if they agree to a fee that is paid after the work is done (such as a contingent fee), and the client comes to believe that it must change counsel and discharge the firm that agreed to that fee, what if anything is due the first firm? What obligation would the first firm have to cooperate with replacement counsel?

The discussion of and agreement on a fee based on something other than the number of hours of work that the assignment entails are not easy subjects to address and resolve in advance. A properly structured fee arrangement can add value to the relationship between the firm and the client by aligning their interests more directly. If poorly negotiated and designed, however, it can introduce complexities into an already-complex situation.

Regardless of the results of such discussions, however, it is important that the client and the firm agree on the terms by which the latter will be paid by the former for its role in the client's work. Even if the parties discuss the issues and agree to a fee that is based on hourly rates, then, the discussions will have a beneficial effect on their situation. This is so because the discussion of issues related to the fee will require that they also address many other issues relevant to the work. They will need to attempt to define the extent that the legal work impacts on the client's business. They will address staffing issues relative to completion of the legal work. They will need to resolve things such as timing, coordination and other items that impact on the amount and type of legal work needed by the client.

In short, the discussions about the fee are important enough. So much so that they should be held regardless of their outcome. By doing so, the firm and its client will better plan the specifics of their relationship. And perhaps that is the most beneficial effect of discussing alternative fees, not whether such fees are in fact entered into.